



**“MARKET STUDY TO EXPAND MICROFINANCE
IN MABS PARTICIPATING RURAL BANKS”**

**USAID’S MICROENTERPRISE ACCESS TO BANKING SERVICES
(MABS) PROGRAM**

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I. Executive Summary

The USAID-funded Microenterprise Access to Banking Services (MABS) Program contracted Financial Services Specialist, Ms. Anita Campion, to conduct this Market Study determine whether or not MABS participating banks are effectively reaching out to the microenterprise market in their respective communities. The consultant concluded that all the rural banks could do more to expand their outreach and offered a number of suggestions to the rural banks and the MABS program, which are summarized below.

Management Recommendations

Rural banks achieving the greatest microcredit outreach have dynamic leaders who are committed to microfinance. Hence, rural banks that are struggling to expand their microloan portfolios need to make sure that their actions as well as their words demonstrate a strong commitment to microfinance. Specifically, senior managers should:

- *Set higher expectations for expansion* and hold branch managers and account officers (AOs) responsible to achieving specific targets, in terms of number of prospects visited, number of loan applications submitted, as well as number of new qualified clients approved for a loan per week.
- *Encourage creativity and innovation* within the bank culture, allowing policies and products to be revised and developed in response to changing market conditions. In addition, management should encourage AOs to be more creative in finding clients, such as home-based businesses, and not relying only on those in the central market.
- *Create appropriate incentives* to encourage branch staff, and especially AOs, to proactively recruit new clients. Salary structures should be revised so that AOs must be more productive to earn a good salary. In addition, management should ensure that incentives are in place to encourage AOs to transition clients from group lending to individual lending and from individual loans to commercial loans as they become eligible.

Product Recommendations

Based on surveys of current and potential clients, rural banks should consider making a number of changes to their products to be more client responsive. These changes include:

- *Increase loan sizes.* The majority of current clients surveyed said they would be more satisfied with their loan if the amount was higher. A review of their cash flow determined that most had the capacity to handle larger loans.
- *Reduce overly restrictive policies.* Several rural banks have established risk control measures in addition to the already conservative MABS-suggested policies, such as requiring additional co-makers or requiring a cash flow

analysis for all co-makers to determine their ability to handle the full loan amount in case of default. These overly conservative policies restrict the number of clients who qualify for a loan or a larger loan size.

- *Consider agricultural income and pre-harvest expenses* in the cash flow analysis used to make loan decisions. The resulting net income should not exceed 20% of the total amount the client will depend on to make the loan payment. Rural banks that are more risk averse should begin by allowing only year round agricultural activities, such as poultry and pig raising, rather than traditional crops, such as rice and corn, which are more risky.
- *Transition compulsory savings to voluntary savings* in line with international best practices. While the forced savings component of the MABS Approach has effectively instilled client discipline and an appreciation for savings, it has become a disincentive for clients to stay in the program, as clients are increasingly tempted to drop out to access growing savings balances.
- *Minimize foreclosure expenses* for loans backed by chattel mortgages. Clients in default often sign a “dacion en pago,” which serves as a bill of sale to transfer ownership of the chattel to the bank or to transfer the asset to a pawn shop. Rural banks can require loan guarantors (usually co-makers) to sign as co-borrowers to make them equally responsible for the loan payment as the initiating borrower. This clarifies the levels of responsibility and facilitates court orders for payment. By minimizing the risks associated with foreclosures, more banks will be willing to offer larger loans.

Marketing Recommendations

All of the rural banks could deepen their understanding of the market and become more client responsive. This will serve to attract new clients and strengthen client retention over the long-term. Specifically, rural banks should do more to:

- *Measure, monitor and improve client retention.* Given the costly and time consuming realities of identifying and attracting new clients, rural banks should increase their understanding of why some clients voluntarily discontinue borrowing. Through client monitoring, especially exit interviews, banks can improve their products or services to better serve clients and thus improve client retention. In addition, the rural banks should consider offering special incentives to good clients, such as interest rate rebates or small gifts, and allow exceptions to the zero tolerance rule for good, long-term clients with legitimate reasons for late payments, such as an extended hospitalization or unforeseen disaster.
- *Formally monitor client preferences.* Most of the rural banks lack a systematic way of regularly measuring and monitoring client satisfaction and preferences, which would allow them to adjust and develop products in response to changing market needs. Based on the client surveys in this market study, for example, rural banks should consider offering seasonal loans to good clients in preparation for peak sales seasons, such as Christmas.

- *Increase the use of formal marketing campaigns* by emphasizing the rural banks' strength in serving clients a broad range of financial services, including checking and savings accounts and loans, as their business needs change and grow. This is a comparative advantage of rural banks which their primary competitors, lending investors and money lenders are unable to offer. According to survey findings, this feature is more important than lower interest rates to most microenterprise clients.

Recommendations to MABS

There are several ways MABS can facilitate the implementation of the above suggestions to help rural banks expand their microloan portfolios. Specifically, MABS should:

- Develop marketing and sales training for managers and AOs and facilitate information sharing through round tables and study tours.
- Offer technical assistance and tools to monitor and measure client satisfaction and retention.
- Work with rural banks to understand the necessity to transition away from compulsory savings to voluntary savings, by providing practical examples that demonstrate how the real costs of borrowing increase as clients' forced savings balances increase.
- Continue to strengthen internal controls and audit systems to increase the confidence of rural banks in their microfinance operations and make them more willing to aggressively expand microlending.

By implementing these recommendations, the MABS participating rural banks will be able to significantly expand their microlending outreach and become an even greater force against the competition. While some of these suggestions will increase risks for the rural banks, with the proper internal controls the banks should be able to significantly increase their loan portfolios and only minimally increase their costs, resulting in higher profits overall.

II. Introduction

The USAID-funded Microenterprise Access to Banking Services (MABS) Program contracted a Financial Services Specialist, Ms. Anita Campion, to conduct a Market Study, the results of which are presented in this report. Chapter II explains the purpose of the study and the methodology used. Chapter III summarizes the key findings and Chapter IV highlights the key recommendations to rural banks on how to strengthen and expand their microenterprise lending. The report concludes with specific recommendations to the MABS program on how to facilitate this expansion.

A. Purpose of the Study

The objective of the MABS program is to “encourage and assist a large number of banks to significantly increase the services they provide to the microenterprise sector.” The program has helped 40 rural banks expand their microlending to 90,000 loan clients over the past four years. As of 8 August 2003, MABS received an extension aimed to help 50 more rural banks and increase microlending by 55,000 new borrowers over the next year. Therefore, the MABS program decided that it was time to reassess market demand for microcredit and determine how banks can better serve microenterprises. Hence, the consultant, Ms. Campion, was contracted to “determine whether or not MABS participating banks are effectively reaching out to the microenterprise market in their respective communities.¹”

B. Methodology


To conduct this market study, Ms. Campion began by meeting with USAID, RBAP and MABS staff to discuss the MABS Approach to helping the participating rural banks understand their market. She then reviewed the current MABS market survey instruments and original survey findings from the participating rural banks to determine the tools’ effectiveness and make suggestions for improvement.

Ms. Campion attended a MABS round table, in which she discussed market potential with 16 participating rural bankers, mostly from Visayas and Luzon. This opportunity helped Ms. Campion to focus her research and design an appropriate interview template for rural bank staff (see Annex 1) and a survey questionnaire (see Annex 2) for current and potential clients of the rural banks.² Ms. Campion visited eight MABS-participating rural banks to discuss their use of the MABS tools and methodology to assess their market. The eight banks were selected to represent a cross selection of MABS participants in terms of geographical location (two from Luzon, one from Visayas, and five from Mindanao) and success in achieving outreach (including successful banks as well as those struggling to find clients; some with

¹ Per the MABS scope of work for the Market Study.

² Current clients were asked to respond to all three pages of the questionnaire, including the first page that asked checked for satisfaction with the current product. Potential clients were only asked questions on pages 2 and 3 of the questionnaire.

group lending and some with only individual loans). All eight banks have worked with MABS for at least two years, and therefore have had a an opportunity to develop their market potential. Table 1 presents the names of the rural banks visited, their location and the name of the President interviewed.

Table 1: Rural Banks Visited for Market Study		
<i>Name of Rural Bank</i>	<i>Branch and Market Visited</i>	<i>President or Primary Contact</i>
First Macro Bank	Dasmarinas, Luzon	Mr. Ricky Ocampo
Bank of Florida	Floridablanca, Luzon	Ms. Teresa David-Carlos
Victorias Bank	San Carlos, Negros Island, Visayas	Mr.  Lopez
Green Bank	Bayugan, Mindanao	Mr. Omar Andaya
RB Talisayan	Talisayan, Mindanao	Mr. Jolito Cuenca, Branch Manager
Network Bank	Panacan Branch, Davao, Mindanao	Mr. Alex Buenaventura
RB Santo Thomas	Santo Thomas, Mindanao	Ms. Rosele Relator Solis
RB Montevista	Montevista, Mindanao	Mr. Percival Cantiller, GM

Using the interview template, Ms. Campion met with the Bank Presidents, Microfinance Program Directors, Account Officers and other staff to:

- explain the purpose of the market study;
- discuss the rural bank's current microfinance products;
- assess how the bank monitors competition and customer satisfaction; and
- gauge their interest in expanding current and potential products.

Ms. Campion next visited the market with an Account Officer from a rural bank. She met with current and potential clients to assess their satisfaction with the existing microloan product and to identify potential product modifications or new products that could help rural banks to increase outreach, and improve client satisfaction and retention.

The key findings of these interviews and surveys are summarized in the following chapter. Given the time limitations, the research did not include a sufficient number of banks and clients for findings to be statistically significant. However, the research identified trends among rural banks that may be generalized to guide the rural banks industry in expanding microlending operations.

III. Key Findings

The market study found that most participating rural banks are using the market assessment tools of the MABS Approach consistently and correctly. None of the rural bankers believe that their bank has achieved its full market potential and interviews with current and potential clients confirmed there remains significant potential for expansion of microlending.

This chapter describes the MABS market assessment tools and how and the extent to which they are used by participating rural banks. Next, it describes the microlending market from the rural bank staff perspective, followed by a summary of clients' needs and preferences for microloans and other financial products as distilled from the market surveys.

A. MABS Market Assessment Tools

The MABS program offers several tools to participating rural banks to assess the market for microenterprise lending, including a template for conducting market surveys of potential or non-clients, client surveys and focus groups, and exit interviews. MABS staff helps the banks to understand the importance of client retention and how to measure and monitor it. Each of the tools are discussed and assessed below.

I. Market surveys

MABS staff assisted all of the rural banks conduct an initial market survey. The survey uses government statistics on population and number and types of formal businesses and then adds an additional 2:1 ratio multiplier for informal businesses to determine if there is adequate market potential for microenterprise loans. The market survey also analyzing market competition, including formal financial institutions (i.e. other banks, cooperatives and lending investors) and informal lenders (i.e. NGOs, money lenders, etc.). The rural banks used the initial market survey to understand the market, including the potential client base and the strengths and weaknesses of the competition. Most of the banks were further using the MABS market survey methodology to assess potential of new markets for expansion. .

Overall, the MABS market survey tool is efficient and effective in gleaning market information. By having the rural bank staff involved in the market research, the results are based on local understanding combined with quantitative information. The only problems with the market research report format is that it lacks guidance on how the rural banks should weigh all the criteria, resulting in weak conclusion statements and a lack of analysis of how all the information was used to determine whether it was a good microfinance market or not. MABS should add a weighting system, along with an explanation on how to summarize the data.

In addition, all the "Other Risk Factors" section of the market survey tool should be worded consistently. For example, A low "rate of out-migration" is good, but a low

rate of “ownership of dwelling” is not good. All factors should be reworded so the best response is either “low” or “high.” In the above example, “ownership of dwelling” could be changed to “lack of ownership of dwelling.” Such consistency would facilitate the analysis.

2. Client surveys and focus groups

Client surveys are an important part of the market survey. Most rural banks conduct client surveys when they enter a new geographical area. One President said his rural bank required candidates for Account Officer (AO) positions to conduct client surveys to test their efficiency and ease working in the market. A few of the rural banks conducted focus groups of existing clients to understand client preferences and desires. While discussions demonstrated that bank staff had a good understanding of their clients’ preferences, there was little formal documentation available to review the findings of such surveys and focus groups and the associated analysis.

The MABS format for the market surveys, client surveys and focus groups are strong in terms of minimizing the information collected to that which is most relevant and useful. The disadvantage of the MABS client survey is that it is geared towards potential clients and does not adequately assess current client satisfaction. The first page of the client survey used for this market research (see Annex 2) could be an alternative tool for rural banks to measure client satisfaction. The other weakness with the MABS client survey is that by being conducted by rural bank staff, there is potential for clients to compromise their answer if they think this might help them get approval for a loan. For example, question 31 asks what type of institution the client would prefer borrowing from. It is not surprising that the response was often “rural bank,” given that the client knew a representative from a rural bank was asking the question. While the rural banks could contract professional market researchers to conduct the surveys, this would be prohibitively expensive for most of the rural banks and not provide much added value for the cost.

3. Exit interviews

A number of rural bankers said they regularly conducted exit interviews, especially those banks that were experiencing higher than average drop outs. Of the exit interview questionnaires reviewed, there were few written summaries, analyzing client responses. Interestingly, the most often cited reasons in one bank in Luzon were “weak condition of my business” and “poor economic conditions.” Few exit interviews indicated that clients were being lost to the competition. However, some client surveys revealed that they took out a loan with competing banks because of the faster processing time and larger loan size offered.

The MABS program offers two exit interview questionnaires – a long and detailed survey and a short, one page survey. The long survey is three pages and overly—detailed and personal. One question breaks down the reasons a client left the program by those that left because the spouse left the client the client is pregnant or has another person to care for. Another question asks the client to rate their own level of poverty; information which is unscientific and therefore, not really helpful to the

bank. Some questions ask for information, such as client age, which can be extracted from the client's loan file.

MABS short exit interview form is more appropriate as it is hard to ask exiting clients to give a lot of their time to the bank and it focuses more on the relevant questions: why are you leaving and do you have any recommendations for the bank?

4. Client retention monitoring

As part of the market share projections form, MABS offers participating rural banks a formula for measuring client retention. However, most of the rural banks are not correctly measuring client retention in that they mix both voluntary and involuntary drop-outs in the equation. Involuntary drop-outs are those clients that the rural bank decides to discontinue due to repayment problems. For voluntary drop-outs, the banks usually include those that are simply taking a break as well as those that have decided to quit the program permanently.

B. Market Potential

Interviews with bank staff revealed that overall the rural banks have a good understanding of their market, clients and competition, as discussed below.

1. Current outreach

Many of the rural banks expressed their gratitude to MABS for helping them expand outreach, not only by offering the microfinance product, but in strengthening other product lines. The banks were especially appreciative of the management information system (MIS), monitoring, and reporting suggestions. Many bankers said they monitor portfolio-at-risk (PAR) and emphasize zero tolerance for delinquency, which they apply to their traditional loans, in addition to their microfinance portfolios.

Defining microenterprise loans. While all the banks make microenterprise loans, there is a broad range of how the banks define their microloan portfolio. Two rural banks confine their microloan portfolio to those loans under 30,000 or 40,000 pesos (US\$566 or 755),³ disbursed without collateral. These two banks also made larger loans to clients with non-traditional collateral, such as appliances, but included these in their commercial loan portfolio. While most of the banks included such chattel mortgage-based loans in their microloan portfolios, with loan sizes as high as 150,000 pesos (US\$2830). Given that these loans are mostly made based on the client's cash flow and not the value of the collateral, rural banks should include all these loans in its microfinance reporting to MABS. The Presidents of the banks that count these loans in the commercial loan portfolios did not think it would be a problem to separate out these loans from their real estate backed loans. However, MABS might have to work with these banks to make sure that consumer loans aren't also being included in the figures.

³ Based on exchange rate of 53 pesos per \$1 as of September, 2003.

Group vs. individual lending. Four of the eight rural banks offer both group lending and individual lending; three banks offer only individual loans; and one bank offers group loans only (with loan size is based on MABS cash flow analysis). The banks that offer group loans have more active loan clients. However, all of the banks recognize the limitations of the group lending methodology and the need to offer individual loans to retain clients, especially in areas with stronger competition. Even the one bank that only offers group loans is in the process of establishing an individual loan product so that larger clients can transition to individual loans. In interviewing a group of 25 group loan clients, the reason why group lending has limited utility was expressed by the clients. When asked how the new clients who would receive a 5,000 peso loan would feel about co-guaranteeing 20,000 peso loans, they answered, “I can’t afford that” and “I guess we would have to part ways.” In addition, several of the group loan clients were frustrated by the limited loan sizes of available to them as some had larger businesses, but their growth was being hindered by the methodology. Two of the rural banks said the main reason they continue to offer group loans is because it allows them to access loan funds from the government apex organization, People’s Credit and Finance Corporation (PCFC).

Growth potential of enterprises. One of the main objectives of the MABS program is to help rural banks expand lending to microenterprises, which will hopefully result in larger businesses that create jobs for other low income people. Based on 16 individual loan client surveys, only two clients added a significant number of employees as a result of the loans. The remaining clients had either hired only one additional employee or retained the same number of employees. These job creation figures are slightly higher than the industry average, which is for only one in ten small businesses to grow significantly. This finding is very positive in that it is better than the industry average, and especially in light of the fact that most microenterprises tend to have even less growth than small businesses.

Of the two enterprises that led to job creation, their growth was significant. One, business grew from five to 19 employees and created an additional business in just three years (see Box 1: Client Success Story below). Another business grew from two to ten employees and added several new products in just three years. For both businesses, loans helped the microenterprises grow into small businesses.

Current sectors targeted. Many of the rural banks focus heavily on public vendors and market centers. Therefore, they lend mainly to sari saris (small grocers) and to few manufacturing clients. The rural banks that have achieved significant outreach were more creative in identifying clients outside the public markets, including home based businesses.

2. Remaining market potential

A recent “Country Study of the Philippines,⁴” funded by ADB, describes the microcredit market as follows:

The total volume of microcredit from formal and semi-formal MFIs combined is unknown, but the estimates of the outstanding balance are in the range PhP 6 billion - PhP 8 billion (\$121 million - \$161 million). Estimates of the number of poor with access to microfinance services range between 600,000 – 1 million people, depending mainly on whether one includes consumer (i.e. salary-based) loans that may be borrowed from rural banks for microenterprise purposes. However, it is clear that even if the upper bound of one million people is served by MFIs, outreach is low compared to the estimated 5.8 million poor households, at slightly less than 20 percent.

Box 1: Client Success Story

Ms. Marilou Villarante has a small business selling dry goods in the San Carlos market. Three years ago Ms. Villarante had only 5 employees, but with the help of Victorias Bank, she has been able to expand her business and create jobs for an additional 14 people. Three years ago, Victorias Bank came to her and offered her a loan of 10,000 pesos to expand her inventory. Since then, she has had six loans from Victorias Bank of increasing loan sizes. These loans have helped her to grow her dry goods business as well as to start a bakery, which she opened 3 months ago. When asked how Victorias Bank has helped her, she said, “It has helped in so many ways. Now, I can afford to live in a nice place and send my children to the Montessori school, as well as pay for help around the house.” For her next loan, Ms. Villarante plans to ask for 100,000 pesos to continue to expand her enterprises and improve her life.

Rural bankers’ assessment of market potential. What is interesting about the statement above is that 20 percent was the average amount of market served by the rural banks according to the Presidents, although the range of responses was from 1% to 60%. Nonetheless, all of the banks believed that there were additional clients that they they could reach that would be interested in and qualify for a microloan.

Potential client surveys. The surveys of potential clients reinforced the fact that there are in fact a number of clients still that don’t have access to a loan and who would be interested. Of the 16 potential clients surveyed, eight said they were interested in a loan and five had never borrowed before. Of the eight potential clients that weren’t interested in a loan, three already had a loan, three didn’t need a loan (had their own capital to fund business) and two didn’t want to be burdened by a loan. It was interesting that the banks struggling to expand operations were in markets where potential clients are less interested in loans, indicating they face either stiffer competition or a less conducive business environment.

⁴ P.vi., by Stephanie Charitonenko, Chemonics International, July 2002.

3. Competition

The main competition for the rural banks are lending investors and money lenders (five-sixers, etc.). While both these types of lenders are less competitive in terms of interest rate (lending at rates as high as 20% per month vs. 2-3% per month), they are more competitive in terms of rapid loan processing and have fewer requirements than the rural banks. The rural banks are aware of the competition and recognize that microenterprise clients value these product features.. As a result, many of the rural banks have tried to reduce their loan processing time. Nonetheless, as formal financial intermediaries, the rural banks are limited in their ability to reduce paperwork and speed up the loan process. While lending investors and money lenders often process loans in a day, most rural banks take a week to process the first loan. For subsequent loans, however, many banks follow MABS' suggestion and prepare the renewal ahead of time so that loans are available on the day the existing loan matures.

C. Client Preferences

Ms. Campion conducted surveys of 16 individual loan clients and 25 group loan clients to assess their level of satisfaction with the existing product and their interest in other products and services. The findings of the survey were compared against the perceptions that rural bank staff had of their clients' preferences. Generally, account officers had a good understanding of client needs and sometimes made suggestions to management. The more successful rural banks had adjusted the microloan product as a result of client input. A few of the less successful banks were not as responsive to clients and AO suggested changes.

In addition, Ms. Campion conducted surveys of 16 potential clients regarding their interest in a microloan, as well as other products. Below is a summary of the most common requests for product modifications or additions.

1. Larger loans

The majority of current clients (12 of 14 individual loan clients and over half of the group loan clients) said they would be more satisfied if the loan size was higher. In reviewing their loan files and their reported sales and net income, most of them could easily afford a higher loan amount. In addition, several clients could offer additional collateral and some had real estate that they would be willing to use to secure the loan. The demand for larger loan sizes was the most frequently raised issue by current clients. Most clients were satisfied with the other loan terms and the branch staff.

2. Seasonal loans

Given that many of the target clients are retail vendors in the public market, it is not surprising that the majority (10 of the 14 individual loan clients) were interested in a seasonal loan to prepare for peak sales seasons, such as Christmas and fiestas. This finding is also not surprising because many of these clients are interested in larger loans year round. Rural banks could use the concept of seasonal loans as a way to test some of their proven clients' abilities to handle larger loans. The banks could offer either larger loans or parallel loans just prior to the high sales season to clients

with at least one year track record of on-time repayment. The benefit of offering a parallel loan is that it would communicate clearly to clients that the situation is temporary and after the season ends, they would return to a smaller loan size. However, a second loan would clearly require more paperwork, than simply making a larger loan. The banks should release such loans at least one month prior to the peak sales season so enterprises can purchase the additional inventory in advance. Higher loans should not be made right at the time of the holiday, such as Christmas. This increases the risk that the loan would be diverted to purchase gifts rather than used as a business investment.

4. ATM cards, smart cards and credit cards

Of the 30 combined current and potential clients surveyed, 14 were interested in access to savings through automatic teller machines (ATMs) and five already had ATM cards. Since half of the respondents are either interested or have an ATM card, rural banks should seek ways to help their clients link into ATM networks. A rural bank included in the research piloted one ATM and despite the high costs of purchasing a machine (approximately \$10,000), the bank concluded it was cost effective. The bank is now buying two more ATMs to install in other branches. RBAP could facilitate negotiating a reduced cost to the rural banks interested in purchasing ATMs or simply linking their clients to existing ATM networks.

The rural banks could offer smart cards to clients, which would allow the loans to be transferred to the cards and available for purchases. The banks could encourage stores to offer discounts to clients, such as those of ADEMI in the Philippines, to promote card use. In this way, the smart card could serve as both a debit and a credit card. While many of the clients surveyed could not fathom having a credit card (and even laughed at the question), seven of the 30 surveyed said they were interested in a credit card to facilitate inventory purchases.

5. Life Insurance

Of the 30 current and potential clients surveyed (excluding group loan clients), seven had life insurance and six were interested in life insurance. This potential product was described as additional insurance to cover the unexpected death of the business owner, rather than “loan protection” insurance offered by several of the rural banks. When asked how much they would be willing to pay for a 100,000 peso death benefit, responses ranged from 30 pesos to 500 pesos per month. In reviewing how much people pay for life insurance, 500 pesos per month seems in line with the competition.⁵ Rural banks are not legally allowed to offer such insurance, but they can partner with an insurance company to assist clients in purchasing life insurance, in addition to an amount that covers the loan balance. This would communicate to the clients that rural banks are concerned about serving all of their clients’ financial service needs. The Rural Bankers’ Association of the Philippines (RBAP) might be

⁵ Insurance companies named included Sun Life, Philippine American Insurance, Insular Life, Philam Life, Zurich Life and Coco Plant Life.

able to help negotiate a reasonable premium for life insurance for interested rural bank customers that could be advertised through the rural banks.

None of these potential product links described above are urgent, but rural banks should consider them to remain responsive to clients' changing financial service needs and expectations.

III. Recommendations to Expand Microlending

This section focuses on recommendations to help rural banks strengthen and expand their microlending operations in a sustainable fashion. Many issues were raised in the interviews that offer insight into how rural banks can further expand outreach to microenterprises. These issues fall under three categories: management issues, product-related issues and marketing issues. The topics are discussed in their order of importance

A. Management

The primary difference between successful versus less successful banks in expanding their microlending operations is that successful banks are guided by leaders with a strong commitment to microfinance, which is demonstrated and reinforced through their actions and policies. This section offers management and leadership suggestions to boards and senior managers of rural banks who are struggling to expand their microloan portfolios.

1. *Set higher expectations.* First and foremost, management must set high expectations of their employees to grow the microloan portfolio, with clear targets for each branch and account officers to achieve. Targets should be set for the number of new qualified loan clients (MABS suggests five per week), prospects visited and loan applications submitted per week. Some rural banks misunderstood MABS' suggestion of five new clients per week as the target number of prospects to visit. Since not all prospects will be interested in or qualify for a loan, a higher number of 10 to 20 prospects must be visited per day to result in five new qualified loan clients per week.
2. *Encourage creativity and innovation.* Senior management must create a working environment conducive to change and innovation. Product development should not be viewed as a one time event, but as ongoing process, requiring regular feedback from staff and clients to assess whether product or policy changes are needed to remain competitive in the market.

Management should encourage AOs to be creative in finding clients outside of the central market, including home based businesses. Management can support this initiative by offering incentives to clients who bring in new, qualified loan clients, such as a basket of groceries, as Mibanco offers in Peru.

3. *Create proper incentives.* Many internationally successful MFIs, such as ASA of Bangladesh, offer low starting salaries but good incentive systems

to their account officers. These MFIs don't have to worry as much about hiring the appropriate people, because only good producers (those that quickly build a large and solid portfolio) will want to keep the job. These MFIs don't have to worry either about firing poor producers, as they usually quit on their own in search of a better paying position. Several of the rural banks currently offer inappropriately high starting salaries, which are a disincentive for AOs to work harder to be eligible for the incentives-based pay. Green Bank, has created an incentive system that allows microfinance AOs to make more money than traditional AOs, thereby making microfinance a more prestigious profession.

Rural banks that have difficulty attracting microloan clients should revise their salary and incentive structures to make sure there is a clear expectation for the AOs to be out in the market the majority of the time (MABS recommends 90% of their time). Rural bank managers must make sure that AOs are not burdened with in-branch tasks that keep them from being out of the branch, meeting with current and potential clients. Another way to reduce costs and free up some AOs' time is to change from daily collections to weekly and bi-monthly collections, especially for clients who have demonstrated strong on-time repayment abilities.

Management should also ensure that there are incentives in place for AOs to transition group loan clients to individual loans and microloan clients to commercial loan clients, in response to clients' need for larger loans as their businesses grow. For example, AOs could receive a one time lump sum benefit to encourage them to transition their clients that qualify for the next level. To determine an effective incentive system, rural banks should discuss with their AOs the amount of money would make it worth it for them to pass off their best paying, highest loan size clients. Smooth transitioning is in the best interests of the banks and clients and should lead to client retention, especially in competitive environments.

B. Product

While all the banks visited employ the MABS Approach, wide variation exists in adaptation to match the risk tolerances of the various banks. Below is a discussion of how some of the banks' overly risk-averse policies may hinder expansion of their microloan portfolios.

4. *Increase loan sizes.* Several of the rural banks have policies that limit the loan sizes that clients can access as a way a minimizing risk. Two of the rural banks limit the maximum microloan to 30,000 and 40,000 pesos respectively. Any amount above that is considered a commercial loan and requires collateral. Other rural banks have higher maximum loan amounts but limit subsequent loans to no more than 20% of the previous loan size. Client surveys showed that these policies were limiting growth for many

microenterprises, who had demonstrated their on-time repayment abilities, thereby hindering the bank's growth.

5. *Reduce other overly conservative policies.* Many of the rural banks add on policies to minimize the risk of default and loss, in addition to the risk control measures already built into the MABS Approach. As a result, many of the banks end up being overly conservative, which limits expansion in terms of new clients, as well as portfolio size. For example, one bank required two co-makers in addition to the co-borrower and required that they were each able to repay the loan in full in case of default, based on a separate detailed cash flow analysis. This requirement resulted in excessive paperwork and limited the number of borrowers who could qualify for a loan.

Other banks used an adjusted repayment capacity (ARC) of only 25% of net income to determine the loan capacity of the borrower. This is already a conservative way of calculating loan repayment capacity, and several AOs reduce the maximum loan amount further "just to be conservative." The more successful banks were using ARCs of from 35% to 50% of the clients' net monthly disposable income. While being less conservative may result in a slightly higher portfolio-at-risk, this was not the experience of the rural banks using less conservative policies, which in fact had higher rates of client retention. Even if less conservative policies result in higher defaults, the additional income gain would likely more than cover the lost income, resulting in an overall net benefit to the bank.

6. *Consider agricultural income and expenses pre-harvest.* Up until now, MABS has always discouraged the use of agricultural income in the cash flow analysis as it is considered a riskier source of income than other business income. However, now that many of the rural banks have demonstrated their abilities and understanding of the MABS Approach, MABS is open to including some agricultural income and expenses into the cash flow analysis. AOs must be careful to factor in the seasonality of agricultural income. Two of the rural banks visited said they have allowed a few clients to access larger loans because they knew the clients were harvesting rice and would have additional income to pay off the loan. These cases were exceptions and had to be approved by the branch manager. Those banks with low PAR ratios over 30 days should consider factoring in some types of agricultural activities into the cash flow analysis.

Both agricultural income and expenses should be involved in the analysis and calculated separately, on the basis of the life of the loan. The resulting net income should not exceed 20% of the amount that the client will depend on to make the loan payment. Rural banks that are more risk averse should begin by allowing only year round agricultural activities,

such as poultry and pig raising, rather than traditional crops, such as rice and corn, which are seasonal and vulnerable to price fluctuations.

Transition compulsory savings into voluntary savings. At the start of the MABS program, it made sense to require compulsory savings from microloan clients as a way to instill discipline and build good savings habits. Now that these savings balances have grown, there is a growing risk of clients' quitting so they can access their savings balances. For example, one loan file reviewed showed that the rural bank had blocked the savings account of the 90,000 pesos for a client who received a 100,000 peso loan and paid 4,000 pesos in fees. So, for a 3 month loan at 3% per month, this client was paying 13,000 pesos to access his savings and borrow another 6000 pesos. The real interest rate paid by this client to borrow 6000 pesos was over 72% per month.

It is not surprising that some clients choose to withdrawal their savings and discontinue borrowing. This has been a common experience with MFIs, resulting in an international best practice that discourages compulsory savings in order to access a loan. Hence, it is recommended that all rural banks begin transitioning away from compulsory savings. To avoid a major outflow of capital, it is not recommended to communicate immediately to all borrowers that their savings are now accessible. Instead, the banks should slowly transition clients to voluntary savings accounts and discontinue requiring additional forced savings in combination with the loan payment. If clients still want to make a savings deposit with each daily or weekly collection, then this should be allowed, but banks should require the clients to commit to a regular deposit amount as a way to minimize fraud. Some savings can be used as a partial guarantee of the loan, but the percentage should be fixed at perhaps 10-15% of the loan. And only that portion of the savings account should be blocked.

7. *Minimize foreclosure costs.* Many of the rural banks require chattel mortgages backed by non-traditional assets, such as TVs and appliances to guarantee loans over 50,000 pesos. However, the costs of foreclosure are prohibitively high given the size of the microloans they cover. Some rural banks have devised creative ways to minimize the high costs of foreclosure. For example, one rural bank has a pawn shop to which it legally transfers its chattel mortgage collateral once the client defaults, which facilitates the sale of the item within 30 days. Other banks have clients in default sign a "dacion en pago," which acts as a bill of sale to transfer ownership of the chattel to the bank. These options help rural banks avoid the cost of lengthy foreclosure procedures and the need to return excess funds to the client after sale of the collateral assets. In addition, rural banks can require loan guarantors (usually co-makers) to sign as co-borrowers so that they are automatically equally responsible for

the loan as the initiating borrower. This clarifies levels of responsibility and facilitates court orders for payment. By minimizing the risks associated with chattel mortgages, more banks will be willing to offer larger loans.

C. Marketing

Even the most successful rural banks could do more to formally monitor client preferences and market their services to microenterprises. Below are some suggestions that could help rural banks to retain and attract more microloan clients.

8. *Formally monitor client preferences.* While many of the rural banks used the initial market study to understand its clients and the market, few have a systematic way of regularly measuring and monitoring client satisfaction and preferences. Especially for those banks operating in competitive environments, it is extremely important to understand client preferences so that policies and products can be adapted as needed. Rural banks should regularly use the MABS tools, including client surveys, focus groups and exit interviews, to measure and monitor client satisfaction and preferences. The results of these tools should be formally documented and collectively reviewed and analyzed quarterly to determine common issues and findings and suggest policy and product changes. Box 2 on the next two pages provides a sample memorandum reporting on the analysis and key findings of the client surveys conducted for this market study, which can serve as a template for future client monitoring reports.
9. *Make efforts to measure, monitor and improve client retention.* Most of the rural banks measure client retention in a broad sense, but few have a clear understanding of the level of and reasons for client desertion. Given the fact that it is costly and time consuming to identify and attract new clients, most of the banks could do a better job of understanding why some clients voluntarily discontinue borrowing. By doing more client monitoring, especially exit interviews, the banks will have a better idea of how to improve client retention.

By being more responsive to client preferences, the rural banks will be able to retain more clients. In addition, the rural banks can offer incentives to good clients, such as the mugs and umbrellas offered by Green Bank, and allow exceptions to the zero tolerance rule for long-term customers who present a legitimate reason for late payments (e.g. extended hospitalization, unforeseen calamity, etc.). These efforts too will improve client retention, while only marginally increasing costs to the banks.

Box 2: Sample Memorandum

To: MABS Participating Rural Banks

From: Financial Consultant, Ms. Anita Campion

RE: Client Survey Results

Date: September 26, 2003

This memorandum is to inform MABS participating rural banks of the key findings resulting from current and potential clients surveys conducted in September 2003. The MABS Financial Consultant with assistance from MABS staff and account officers of the 8 banks surveyed, conducted a total of 57 surveys, which included 39 current clients (14 individual loan clients and 25 group loan clients) and 16 potential clients. Below is a summary of common survey responses along with an analysis of the implications for these key findings.

Key Findings

Customer Satisfaction: All 39 current clients rated themselves as either "satisfied" or "very satisfied" in terms of their level of overall satisfaction with their rural bank. However, 12 of the 14 current individual loan clients said they were "unsatisfied" with their loan size, which they rated as "important" to them. While the 25 group loan clients all said they were "satisfied" with their loan size, when asked how their level of satisfaction could be improved, over half of them said they would prefer a larger loan.

New Product Development: There were three new products that current and potential clients expressed a significant interest in: seasonal loans, ATM cards and life insurance.

Seasonal loans. Of the 14 current individual loan clients, 10 said they would be interested in a seasonal loan to prepare for peak sales seasons, such as Christmas and for fiestas, in addition to their current loan. Of the 25 current group loan clients, 15 said they would be interested in a seasonal loan.

ATM cards. Of the 30 current and potential clients surveyed (excluding group loan clients), 14 were interested in access to savings through automatic teller machines (ATMs) and 5 already had ATM cards.

Life insurance. Of the 30 current and potential clients surveyed (excluding group loan clients), seven had life insurance and six were interested in life insurance. Those that had life insurance paid from 233 pesos to 633 pesos per month per 100,000 pesos of death benefit, with the most common payment being 500 per month. Those interested said they would be willing to pay between 30 pesos and 500 pesos per month for a death benefit of 100,000.

Analysis of Findings

Given the above findings, rural banks should look into ways to:

- *Increase loan sizes* for existing and new microloan clients, as a way to improve customer satisfaction and retention. The rural banks should consider increasing maximum loan sizes allowed within the microloan portfolio and increase the amount of loans that can be approved without requiring a chattel mortgage. The banks should also review other policies that might be hindering larger loan sizes for clients who can afford to repay them, such as the maximum percent increase allowed for each subsequent loan.
- *Pilot test seasonal loans.* To be cautious, the banks could begin by offering them to only clients that have at least one year of experience borrowing from the bank and have repaid 100% on time.
- *Conduct a feasibility study for ATM cards.* Since half of the respondents are either interested or have an ATM card, rural banks should seek ways to help their clients link into ATM networks.
- *Assess the possibility of offering life insurance* by identifying potential partnership options and conducting feasibility studies to determine the costs and benefits that such a partnership would yield. However, given the lower level of interest in life insurance compared to seasonal loans and ATMs, this should be given lower priority than the other new product possibilities.

10. Increase the use of formal marketing campaigns. The rural banks could be more pro-active in finding new clients by conducting formal marketing campaigns, including radio advertisements, hanging banners and handing out flyers. While many of the rural banks consider their competitive advantage to be lower interest rates, compared to lending investors and money lenders. However, microloan clients are less interested in interest rates and more interested in having regular access to a loan. Therefore, rural banks should market themselves as the one-stop shop for microenterprises' full range of financial service needs, including checking, savings, and loans, since this is the rural banks' real strategic advantage.

RBAP should continue to support this initiative by emphasizing this strength in press coverage and promotions of the rural banks.

V. Recommendations to MABS

Based on the findings of this market study, this chapter emphasizes how MABS can support the rural banks in implementing the recommendations in Chapter IV and assist them in achieving their maximum microcredit outreach potential.

1. Conduct Marketing Training and Facilitate Information Sharing

To strengthen the rural banks' ability to effectively market their microfinance products, the MABS team should plan and organize training for the banks on how to be more sales and marketing oriented. MABS should begin with a round table orientation for senior managers to build a firm commitment to becoming more marketing-oriented at the highest levels of the bank. Then, MABS should provide more detailed training to branch managers and AOs on their roles and responsibilities for expanding the microloan portfolio. In addition, MABS could organize roundtable for AOs to share experiences and advice on how to prospect and market new clients, building on innovative approaches used by rural banks that have been successful in developing their microloan portfolios. MABS could also facilitate study tours for poorly performing AOs to shadow good AOs of more successful rural banks.

2. Offer Tools to Monitor and Measure Client Satisfaction and Retention

MABS can help the rural banks to understand the importance of monitoring client satisfaction and desertion more closely and offer training and/or round tables on best practices in "building customer loyalty." MABS should download the publication "Building Customer Loyalty" by Sahra Halpern and Craig Churchill from the MicroFinance Network's website at www.mfnetwork.org, distribute to the participating rural banks and use it to develop appropriate tools for measuring and monitoring client satisfaction and desertion. The client survey used in this Market Study (see Annex 2) was adapted from this publication. Using practical examples, MABS should help the participating rural banks to understand the cost of losing good clients. For example, Mibanco of Peru estimates that it takes four repaid loans before it recovers the cost of identifying a new client.

3. Transition Rural Banks Away from Compulsory Savings

MABS will likely need to work with the rural banks to understand how compulsory savings increases the real cost of lending and borrowing and acts as an incentive for clients to drop out. This will likely be a slow process as many of the banks are convinced that the clients like the savings component of the product. Most clients, like the ability to save regularly, which they can continue to do with a voluntary savings account. Few would likely choose to keep their savings blocked if given the choice. MABS will have to train and convince its own staff on why MABS is proposing this move away from the original methodology. Practical examples, such

as those on page 13, will help the MABS staff and bank staff to understand why this change is needed, now that savings accounts have grown large.

4. Continue to Strengthen Internal Controls and Audit Functions

To ensure that increased growth doesn't lead to fraud, high delinquency, or default, MABS should continue to work with the rural banks to strengthen their internal controls and audit functions. Many of the rural banks have experienced some fraud in association with their microloan portfolios and have a heightened awareness of the need for internal controls. MABS should continue to emphasize that internal controls for microfinance are different than for traditional lending. For example, MABS should continuously suggest that the rural banks appoint someone other than the AO to regularly visit microloan clients to verify their existence and check their account balances. While MABS has already conducted a number of trainings on fraud controls, additional training or round table discussions other types of internal controls that help to mitigate risk would be beneficial.. As the rural banks gain confidence in their abilities to manage the risks associated with microlending, they will feel more comfortable aggressively marketing and expanding their loan portfolios.

Annex 1 – Rural Bank Interview Questionnaire

MARKET RESEARCH QUESTIONNAIRE FOR MABS RURAL BANKS

1. INTRODUCTIONS, PURPOSE OF ASSIGNMENT

Objective of consultancy: to examine the market research conducted by the rural bank and to assess the potential for expanding microfinance in that market.

Methodology: Information will be collected from the rural bank, including managers and loan officers and if possible, from a couple current and potential clients.

Rural Bank Role: For this consultancy to be successful, we will need your cooperation in obtaining information on your bank, your employees (especially those involved with market research) and clients.

Benefit to your rural bank: The findings of this assessment will be available to you, which should help you to have a better understanding of your market and the quality of your market research. However, the information collected from your rural bank will be treated as private, proprietary information and will not be shared with other rural banks or competitors. Specific findings related to your rural bank will only be shared with you, USAID and MABS project staff.

2. REVIEW MICROCREDIT LOAN METHODOLOGY

Review loan files for one approved and one rejected loan, review cash flow analysis and discuss loan decision process with loan officers. Review policies and what types of income are considered (e.g. secondary agricultural income?).

3. DISCUSS MFI'S CURRENT PRODUCT LINES

A. Existing product line – have them describe in their words the features, strengths and weaknesses.

For your microcredit product:

- 1) Who is your target market? (gender, income level, geographical areas, loan size, etc.)
- 2) What is the size of the market? (# clients)
- 3) How many active clients do you currently serve?
- 4) Current outstanding loan portfolio in pesos?
- 5) Range of loan sizes?
- 6) Average loan size?
- 7) Range of terms (maturity)?
- 8) Average maturity?
- 9) Interest rate?
- 10) Fees?

- 11) Portfolio at risk (PAR) over 30 days due rates?
- 12) Client retention rates?
- 13) Average number of days to process loan?
- 14) Average distance client travels to reach branch?
- 15) Branch hours? Days open?

B. Competition. For each product:

- 1) Who is your competition now?
- 2) What do they offer that is more attractive?
- 3) What do you offer that is more attractive?
- 4) How do you distinguish yourself from the competition in your marketing efforts?
- 5) Who do you see as your greatest competition in the future?

C. Customer satisfaction:

- 1) How have you measured customer satisfaction in the past?
- 2) What efforts have you made to keep customers satisfied?
- 3) What system do you have for collecting client feedback and responding to complaints?
- 4) What are the most common client complaints?

4. MFI OBJECTIVES IN MARKET DEVELOPMENT

What would you most like to learn related to marketing and product development in the future?

- how to retain clients?
- how to improve productivity/reduce costs?
- how to expand market outreach?
- how to improve cost recovery or profitability?
- other?

Is there a particular target market you are interested in?

- gender
- income level
- rural/urban/geographical area
- industry segment
- other?

5. NEW PRODUCT POSSIBILITIES

Which new product ideas are the most appealing to your MFI?

- adaptations of existing products
- new technologies (ATM/debit cards, use of Palm Pilots, credit scoring)
- new loan products – revolving credit line, seasonal loans, Islamic loans
- new insurance product links – life, health, disability, property

Annex 2 – Client Survey

Name _____

__ Male __ Female

City _____

I. Current Product Satisfaction

	How satisfied are you? 1 – Unsatisfied 2 – Neutral 3 – Satisfied			How important is this? 1 – Unimportant 2 – Neutral 3 – Important		
Product Design						
1. Loan size	1	2	3	1	2	3
2. Loan term	1	2	3	1	2	3
3. Interest rate	1	2	3	1	2	3
4. Fee	1	2	3	1	2	3
5. Payment frequency	1	2	3	1	2	3
Customer Service						
6. Speed of loan application process	1	2	3	1	2	3
7. Speed of loan disbursal after application	1	2	3	1	2	3
8. Friendliness of account officer	1	2	3	1	2	3
9. Account officer understands my needs	1	2	3	1	2	3
10. Other branch staff were courteous	1	2	3	1	2	3
Office Environment						
11. Hours of operation	1	2	3	1	2	3
12. Facilities are clean	1	2	3	1	2	3
13. Convenient location	1	2	3	1	2	3
General						
14. My overall level of satisfaction with the rural bank is: <input type="checkbox"/> Strongly dissatisfied <input type="checkbox"/> Dissatisfied <input type="checkbox"/> Neutral <input type="checkbox"/> Satisfied <input type="checkbox"/> Very satisfied						
15. What I like best about the rural bank is: _____ _____						
16. My satisfaction would improve if the rural bank made the following changes: _____ _____ _____						
17. I plan to use the rural bank's services again in the future: <input type="checkbox"/> Strongly disagree <input type="checkbox"/> Disagree <input type="checkbox"/> Neutral <input type="checkbox"/> Agree <input type="checkbox"/> Strongly agree						

II. New Product Preferences

1. What type of business do you have? Describe _____

- a) __ garment b) __ handicrafts c) __ food processing d) __ wood/furniture
e) __ metal/industrial f) __ retail/trade (sari sari) g) __ wholesale trade (rice dealers)
h) public market vendor i) __ restaurant (carinderias, eatery, bakery) j) __ transportation (tricycle) k) __ manufacturing l) __ service industry (beauty parlor/barber, shoe repair)
m) __ fishing (non-crop agriculture) n) __ agricultural (crop) o) other _____

2.1 How many years in business? _____ years 2.2 Number of employees? _____

3. What are your main inputs (items you purchase)? _____

4. Who is your supplier company? _____

5. Does your supplier offer you credit? Y N

6. Do you rent any items currently? If so, what? _____

7.1 If offered favorable terms, would you be interested in a loan (if active borrower, would you be interested in a loan upon maturity)? Y N **(If no, go to 9)**

7.2 If yes, for what amount? _____PhP

7.3 What are your average gross monthly sales? _____PhP

7.4 How much per month of your disposable income could you pay?
_____PhP

7.5 What can you offer to secure a loan?

- a) __ real estate b) __ inventory c) __ appliances d) __ car/vehicle e) __ gold
f) __ cash/savings g) __ co-signer h) __ other _____

8. If unwilling to take a loan, please indicate the reason:

- a) __ lack of collateral b) __ lack of documents c) __ lengthy procedures d) __ no need
e) __ religious reasons f) __ don't like to be in debt g) __ other _____

9.1 If unwilling to take loan for religious reasons, would you be interested in receiving advance funds in exchange for a share of the profits? Y N **(If no, go to 10)**

9.2 If yes, what percentage of your profits would you be willing to share? ____%

10. Are you interested in and have you had any of the following financial services in the past?

Product	Interested	Have	Had	Institution	What I liked:	What I disliked:
Working capital loan						
Fixed asset loan						
ATM/Debit card						
Seasonal credit loan						
Credit card						
Life insurance						

11. If interested in life insurance, what amount would you be willing to pay per month to have a benefit of 100,000 pesos? _____

12. Is your business formally registered? Y N

